A "BONA FIDE" LOOPHOLE FOR DEALERS: THREE-YEAR PROTECTION FROM SECTION 12(a)(1) ACTIONS UNDER THE 1933 ACT

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> The emphasis is on disclosure; the philosophy of the Act is that full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.—Justice William Douglas[1]

I. INTRODUCTION

The goal of the Securities Act of 1933 ("the Act") is to protect investors.[2] The Act protects investors by requiring anyone who wishes to sell a security to provide potential investors with the information needed to make an informed purchase decision.[3] For newly issued securities, this information is contained in a registration statement filed with the United States Securities and Exchange Commission ("SEC"). Section 5 is the heart of the Act. It, along with associated SEC rules, governs the actions of issuers, underwriters, and dealers in securities covered by this registration statement. The Act and rules provide the SEC with powers to prevent the sale of these securities by refusing to declare the registration statement "effective," and by "stop orders" after it is declared effective.[4] The SEC may also order anyone who violates the provisions of the Act to "cease and desist,"[5] may pursue them civilly for

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1. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 77 (1959) (discussing the Securities Act of 1933).

2. S. 875, 73d Cong., at 1 (1933), *reprinted in* FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 89 (1983); *see also* Colonial Realty Corp. v. Brunswick Corp., 257 F. Supp. 875, 879 (S.D.N.Y. 1966). The investor protection goal can be seen underlying many provisions of the Act. For example, section 10, indicating what information is compulsory in one of the main documents required under the Act, states that "there may be omitted from any prospectus any . . . information . . . which the Commission may . . . designate as not being necessary . . . for the protection of investors." Securities Act of 1933, 15 U.S.C. § 77j(a)(4) (2000).

3. *Variable Annuity Life Ins. Co.*, 359 U.S. at 77.

4. 15 U.S.C. § 77h (2000).

5. *Id.* § 77h-1.

violations,[6] or may make referrals to the Department of Justice for criminal prosecution.[7] The Act also provides private remedies for investors to pursue anyone who offers or sells securities in violation of the Act.[8]

This article discusses a "loophole" in one of these private causes of action—the remedy provided under section 12(a)(1). Section 12(a)(1) provides investors with a private cause of action for violations of section 5. The loophole allows dealers in unsold allotments of securities to avoid liability under this section three years after the initial offering. Several courts have recognized this loophole. Though seemingly small in practical application, it nonetheless "defeats the very core principle upon which [section 5] is based,"[9] that is, the protection of all investors provided by full disclosure.

Part II will overview the prohibitions of section 5 of the Act, and discuss the exemptions available from these prohibitions under section 4. Part III will discuss the private causes of action that section 12 of the Act creates for violations of section 5, and the time limitations imposed upon these actions by section 13. Part IV will identify and discuss the loophole these sections create for dealers. Part V will review the legislative history and other provisions of the Act to determine if Congress intended the loophole, allowing dealers in unsold allotments to be exempt from private actions for violating section 5 after three years. Part VI will survey the various methods the courts have used to deal with this issue. Part VII will discuss the effectiveness of current solutions and suggest a legislative change to section 13 to eliminate the loophole.

II. SECTION 5 PROHIBITIONS AND SECTION 4 EXEMPTIONS

A. Section 5 Prohibitions

The primary means by which the Act protects investors is through the prohibitions of section 5.[10] Section 5 prohibits certain actions during the pre-filing period (the time after which an entity decides to issue securities but before a registration statement is filed with the SEC), the waiting period (the time after the registration statement is filed but before the SEC deems it

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6. *Id.* § 77q.
7. *Id.* § 77t(b).
8. *Id.* §§ 77k-77l.
9. LeCroy v. Dean Witter Reynolds, Inc., 585 F. Supp. 753, 760 (E.D. Ark. 1984).
10. *See* 15 U.S.C. § 77e.

effective), and the post-filing period (the time after the SEC deems the registration statement effective).[11]

During the pre-filing period, one cannot "offer"[12] to sell the security that the company is making plans to sell.[13] The practical application of this prohibition is to allow only communications between the issuer and the lead underwriters.[14] This allows issuers to set up their selling apparatus while prohibiting conduct that would arouse prospective investors before there is publicly-available information about the issuer and security.

During the waiting period, one cannot transmit a "prospectus"[15] unless it meets the specific requirements of section 10.[16] Only a preliminary prospectus, also known as a "Red Herring," is allowed during this period.[17] Additionally, under Rule 460, the SEC will not accelerate the effective date of the registration statement unless the Red Herring has been sent to all underwriters and dealers,[18] and, under Rule 15c2-8, the underwriters, brokers, and dealers are required to distribute the Red Herring to everyone to whom they expect to sell the security.[19] The overall effect of this regulatory scheme is to require the use of the Red Herring, and only the Red Herring, during the waiting period. This ensures a controlled flow of information to the investors about the security proposed to be sold to public investors.

During the post-filing period, issuer, underwriter, and dealer are prohibited from transmitting a sales invoice or the security itself unless accompanied by the "final prospectus," or the one approved at the effective date by the SEC.[20] This requirement is supplemented by section 10(a)(3), which requires that any final prospectus used more than nine months after the

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11. *Id.* § 77e(c); *see also* 69 AM. JUR. 2D *Securities Regulation—Federal* § 288 (1993).

12. Defined in the Act as "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 15 U.S.C. § 77b(a)(3).

13. *Id.* § 77e(c).

14. *See id.* §§ 77e(b), 77j.

15. Defined in the Act as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." *Id.* § 77b(a)(10).

16. *Id.* § 77j.

17. *Id.* § 77e.

18. 17 C.F.R. § 230.460 (2004). This is a powerful incentive, because without a grant of acceleration from the SEC, a company would have to wait twenty days from the last amendment of the registration statement before it became effective and sales of the security could commence. 15 U.S.C. § 77h(a). Since the registration statement is normally amended the day before sales are to begin when the final underwriting agreement is signed, these companies rely on the acceleration of the effective date.

19. 17 C.F.R. § 240.15c2-8 (2004).

20. 15 U.S.C. § 77e(a).

effective date must be updated to contain information[21] no more than sixteen months old.[22] This ensures an ongoing flow of current information to prospective public investors in the security to be sold under the registration statement.

All of these prohibitions are aimed at protecting investors by producing an information-rich environment surrounding securities being sold in so-called "public offerings." If the information necessary for investors to make informed purchase decisions is not available, then one may not sell securities to investors.

B. Section 4 Exemptions from Section 5 Prohibitions

Read literally, the section 5 prohibitions described above apply equally to everyone: the issuer of the security, members of the underwriting syndicate, brokers, dealers, and even private investors.[23] Section 4 operates to limit this application to those situations where the investor purchasing the security needs the protection of the Act. Generally, investors not needing the Act's protection have some combination of professional business savvy, independent access to information about the issuing company, or financial resources sufficient to bear the risk of the investment.[24]

Section 4(1) states, "The provisions of section 5 shall not apply to . . . transactions by any person other than an issuer, underwriter, or dealer."[25] This provision limits the application of the section 5 prohibitions to only the issuing company, the members of the underwriting syndicate, and the dealers actually selling the securities.

Section 4(3) further states:

> The provisions of section 5 shall not apply to . . . transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except . . . transactions as to securities constituting the whole or a part of an

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21. The final prospectus is required to contain nearly the same information as the registration statement. *Id.* § 77j(a)(1). This includes identifying information of the issuer and the underwriters, a description of the securities, and financial information about the issuer including the balance sheet and profit/loss statement. *Id.* § 77aa.

22. *Id.* § 77j(a)(3).

23. *See id.* § 77e.

24. *See*, *e.g.*, 17 C.F.R. § 230.501 (2004). These SEC Rules provide exemptions from registration for transactions involving investors with these types of sophisticated qualities, deciding that they do not need the protection afforded by normal section 5 registration.

25. 15 U.S.C. § 77d(1).

> unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.[26]

The effect of this provision is to exempt the dealer from the prohibitions of section 5, but then make the exemption unavailable in a situation involving unsold allotments of securities in public offerings. Removal of the exemption means that section 5 requires a dealer to deliver the final prospectus.[27]

This exclusion for dealers[28] is derived from the general purpose of the Act, that is, the protection of investors in public offerings.[29] Normally, in the post-effective period, a securities dealer will be selling a security that is already being traded in a public market. Because of the information reporting requirements imposed by this Act[30] and the Securities and Exchange Act of 1934,[31] there is already ample public information available about such a security for the investor. The protections afforded by section 5 are therefore unnecessary.[32]

When dealing with an unsold allotment of securities, however, Congress determined that investors still need protection. An unsold allotment is a portion of the original issue of securities that the dealer has not yet sold to the public. These securities are being sold for the first time into the public markets and investors purchasing them are still entitled to the protection of the information provided by the final prospectus through section 5. A dealer selling securities from an unsold allotment must, then, comply with the prospectus filing requirements of section 5.

Therefore, after applying section 4, the prohibitions of section 5 are limited in practical application to the issuers of the securities, the members of the underwriting syndicate, and dealers in certain situations, including those dealing in unsold allotments of securities.[33]

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26. *Id.* § 77d(3)(c).

27. *See supra* Part II.A.

28. Note that underwriters no longer involved in the offering are also included when referring to "dealers." 15 U.S.C. § 77d(3).

29. S. 875, 73d Cong., at 1 (1933), *reprinted in* FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 89 (1983).

30. 15 U.S.C. § 77e.

31. 15 U.S.C. § 78a-78mm.

32. Note that dealers must still follow section 5 until forty days after the effective date of the registration statement (ninety days for an initial public offering) to ensure this public information has had time to develop. *Id.* § 77d(3)(B).

33. 15 U.S.C. § 77b(a)(11) (2000). Section 5 may also apply to resales of restricted securities, or sales by investors of unregistered securities previously sold under an exemption from registration, but this is because the investor may be deemed a statutory underwriter under 15 U.S.C. § 77b(a)(11).

III. SECTION 12 PRIVATE ACTIONS AND SECTION 13 TIME LIMITATIONS

A. Section 12 Private Actions

Because the Act's primary purpose is to protect investors, several private causes of action are created for investors to pursue those who would try to deceive investors in a sale. One of these is section 12, creating private causes of action for investors who purchase a security that was offered or sold either in violation of section 5 or with misleading information once the information is made available.[34] Section 12(a) reads:

> Any person who . . . (1) offers or sells a security in violation of section 5 . . . or (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . . shall be liable . . . to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.[35]

Two distinct actions are created here. The first, created by section 12(a)(1), is for the purchaser of any security sold in violation of section 5 as described above.[36] The second, created by section 12(a)(2), is for the purchaser of a publicly offered security where the documents produced in accordance with section 5 contain false or misleading statements or material omissions.[37] Each of these actions allows an investor to rescind the deal, getting back the price they paid for the security.[38]

B. Section 13 Time Limitations on Section 12 Causes of Action

Investors are limited in the time they have to pursue each of these private causes of action.[39] Section 13 outlines two time limits: a one-year limit and a three-year limit.[40] That section provides, in part:

> No action shall be maintained to enforce any liability created under section 11 or section 12(a)(2) . . . unless brought within one year after the discovery of the untrue statement

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34. 15 U.S.C. § 77*l*.
35. *Id.* § 77*l*(a).
36. *Id.* § 77*l*(a)(1).
37. *Id.* § 77*l*(a)(2).
38. *Id.* § 77*l*(a).
39. *Id.* § 77m.
40. *Id.*

> or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 12(a)(1) . . . , unless brought within one year after the violation upon which it is based . . . .[41]

Therefore, an investor cannot bring an action more than one year after the discovery of the violation prompting the action.

Section 13 further provides, "In no event shall any such action be brought to enforce a liability created under section 11 or section 12(a)(1) . . . more than three years after the security was bona fide offered to the public, or under section 12(a)(2) . . . more than three years after the sale."[42] This is generally held to create an absolute time bar of three years, regardless of the date the violation is discovered.[43] These time limits are considered more than mere statutes of limitations. "[T]he general rule is that compliance with any applicable federal statute of limitations contained in the securities laws must be pleaded, since these are often interpreted as conditions precedent to the plaintiff's right of action."[44]

Note, though, that section 12(a)(2) actions cannot be brought more than three years after the "sale" and section 12(a)(1) actions cannot be brought more than three years after a "bona fide offer[ing] to the public."[45] It is this simple difference of words that creates the loophole addressed in this comment.

IV. THE ANOMALOUS LOOPHOLE PRODUCED BY SECTION 13 AND SECTION 4(3)

When the section 13 time limitations on section 12 actions are combined with the exemptions provided by section 4(3) for dealers, a strange loophole arises with respect to securities dealers who sell from their unsold allotments in a public offering.

As discussed above,[46] securities dealers selling previously unsold allotments of public offerings may not claim the dealer exemption set forth in section 4(3).[47] The private cause of action created by section 12(a)(1) permits

41. *Id.*
42. *Id.*
43. *See infra* Part VI.A-B (discussing courts' differing interpretations of this provision).
44. 69A AM. JUR. 2D *Securities Regulation—Federal* § 993 (1993).
45. 15 U.S.C. § 77m.
46. *See supra* Part II.B.
47. 15 U.S.C. § 77d(3)(c).

investors to bring suit against these dealers for violations of section 5, for example, for failure to deliver a final prospectus in the post-effective period. The private cause of action created by section 12(a)(2) permits investors to sue for false or misleading statements or omissions.[48] These actions are limited in time, though, by section 13.[49]

The time limitations of section 13 on a section 12(a)(2) action place an absolute time bar on the cause of action of three years from the time "of sale."[50] This creates no problems for unsold allotments of securities because the time limit does not begin to run until the sale of the unsold allotment occurs. Therefore, investors have three years after they purchase the security until the time expires for a suit based upon a false or misleading statement.

The time limitation of section 13 on the section 12(a)(1) action, however, is triggered by a different event. Section 13 creates an absolute[51] time bar for section 12(a)(1) actions of three years "after the security was bona fide offered to the public."[52] This creates an anomaly in the statute: a dealer could hold an allotment of securities for three years after the securities were initially offered to the public, but if that dealer sells those securities to an investor after those three years have passed without delivering a final prospectus, the investor would be time barred from filing a section 12(a)(1) action against the dealer for the section 5 violation. The result is a loophole whereby dealers become insulated from section 12(a)(1) actions filed by investors.[53]

Dealers in this situation do not, therefore, have to comply with section 5. Normally, they would be required to supply a final prospectus to the investor during the post-effective period.[54] Working within this loophole, though, they do not have to supply a prospectus, or any information, to investors.[55] This would seem to be directly at odds with section 4, which explicitly removes the dealer's section 5 exemption when dealing in unsold allotments of securities.[56] Further, it is inconsistent with section 10(a)(3), which requires a prospectus

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48. *Id.* § 77*l*.

49. *See supra* Part III.B.

50. 15 U.S.C. § 77m.

51. Although some courts have questioned the absoluteness of this time limit on actions, most courts have found the limit non-tollable and absolute. *See infra* Part VI.C. (discussing the courts' various approaches to this issue).

52. 15 U.S.C. § 77m.

53. Note that section 4 includes as dealers any "underwriter no longer acting as an underwriter in respect of the security involved." *Id.* § 77d(3).

54. *Id.* § 77e; *see supra* Part II.A. (discussing effective period prohibitions under section 5).

55. LeCroy v. Dean Witter Reynolds, Inc., 585 F. Supp. 753, 761 (E.D. Ark. 1984).

56. 15 U.S.C. § 77d(3)(c).

used more than nine months after the effective date to contain updated information no more than sixteen months old.[57]

Courts facing this issue have recognized that the potential exists for "unscrupulous brokers to act with impunity after the third year following the initial public offering."[58] This result "undermines the Act's fundamental policy of ensuring that investors possess (or have the opportunity to possess) a modicum of information about the securities they ultimately purchase."[59]

V. RATIONALE OF CONGRESS

Because this result seems to be explicitly at odds with the goals of the Act, one must determine Congress's rationale behind choosing the time the securities are "bona fide offered to the public" instead of the time "of sale" as the trigger for the time limitation on section 12(a)(1) actions before proposing a solution.[60] Did Congress choose the language "bona fide offered" for a specific purpose? Did Congress decide to start two actions at the time of "sale," and another at the time of the "bona fide offer[ing]" for a reason?[61] To attempt to determine congressional intent, the legislative history of section 13 and several provisions of the Act itself will be reviewed.

A. Legislative History of Section 13

There is surprisingly little in the way of organized legislative materials for the Act, considering its importance and the significant amount of litigation surrounding it.[62] The Federal Bar Association's attempt to fill this "absence of a published compilation of the legislative materials for all the federal securities laws and amendments" is the best compilation to date.[63] To determine the intent behind the time limitations in section 13, we look first to the individual Senate and House bills, then to their merger in conference into the first version of the Act. Finally, the subsequent major amendments to section 13 will be reviewed.

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57. *Id.* § 77j(a)(3); *see also* 69 AM. JUR. 2D *Securities Regulation—Federal* § 289 (1993).

58. *LeCroy*, 585 F. Supp. at 761; *see also* Ballenger v. Applied Digital Solutions Inc., 189 F. Supp. 2d 196, 200 (D. Del. 2002).

59. *LeCroy*, 585 F. Supp. at 760.

60. 15 U.S.C. § 77m.

61. *Id.*

62. FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at iii (1983).

63. *Id.*

The 1933 Senate bill sent to conference, S. 875, stated that actions, civil or criminal, "shall not be brought after the expiration of five years after the date such false or deceptive representation was made."[64] The intent of this provision seems to be to provide a simple time limitation of five years after the violation's occurrence on all actions created by the proposed new securities law.

The much more detailed 1933 House bill sent to conference, H.R. 5480, stated:

> No action shall be brought to enforce any liability created under sections 11 or 12 of this Act [covering the same general areas as sections 11 and 12 of today's Act] unless brought within two years after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the cause of action is based upon a violation of section 5 of this Act [the same as section 5 of today's Act], unless brought within two years after such violation. In no event shall any such action be brought after ten years after the security was offered to the public.[65]

This more detailed bill splits the time limitations into two categories. Shorter time limits start with the constructive discovery of the violation. A final time limitation is also created independent of the discovery date. One difference from the Senate bill is the extension of this final limit to ten years. More importantly, the House bill starts this final time limitation from the time when the security was "offered to the public."[66] The intent still seems to be to provide an overall time limit to any actions under the new securities laws.

The bill resulting from the conference between the two houses of Congress, and which eventually became today's Act, more closely resembled the House bill. The portion describing the overall time limitation stated, "In no event shall any . . . action be brought to enforce a liability created under section 11 or section 12 (1) [now section 12(a)(1)] more than ten years after the security was bona fide offered to the public."[67] There is, somewhat strangely, no mention of any absolute time limit on section 12(a)(2) [then called section 12 (2)] actions. The only restriction placed on section 12(a)(2)

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64. S. REP. NO. 47, at 51 (1933), *reprinted in* FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 77 (1983).

65. H.R. REP. NO. 85-5480, at 26 (1933), *reprinted in* FEDERAL BAR ASSOCIATION, SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 124 (1933).

66. *Id.*

67. H.R. CONF. REP. NO. 152-5480, at 12 (1933), *reprinted in* FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 263 (1983) (discussing the Securities Act of 1933).

actions was the two-year limit after the actual violation, language taken verbatim from the House bill, H.R. 5480.[68]

Unfortunately, there is no mention of section 13, or any rationale for the enacted version of this section, in the conference committee notes.[69] The rationale of Congress for choosing the time of offering, or the use of the phrase "bona fide" in this version of section 13, therefore, is difficult to determine at this point in the Act's evolution.

One year later, in 1934, the Act was amended

> (a) by striking out "two years" wherever it appears therein and inserting in lieu thereof "one year"; (b) by striking out "ten years" and inserting in lieu thereof "three years"; and (c) by inserting immediately before the period at the end thereof a comma and the following: "or under Section 12 (2) [now section 12(a)(2)] more than three years after the sale."[70]

This amendment creates, for practical purposes, the issue being addressed here.

The original Act contained a ten-year time limitation on section 12(1) violations (which would become section 12(a)(1) violations under today's Act).[71] It is unlikely that any unsold allotments would remain ten years after an offering. When the time limit was changed to three years, though, it suddenly became more plausible that dealers could hold securities for three years and have immunity from private actions for violating section 5. It is with this 1934 amendment, then, that the anomaly discussed here is created. Again, the committee notes do not specifically address the rationale for this change, and the real reason for this change from a ten-year limitation to a three-year limitation is not readily apparent.

Unfortunately, although the legislative history shows how and when the anomaly was created, it does not provide any insight into whether or not it was created intentionally. The mere fact that the anomaly resulted from a series of compromises and amendments, though, tends to favor the theory that it was not intended, but instead was an unintended result of this process.

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68. *Id.*

69. *Id.* at 275-80.

70. Securities Act of 1933, ch. 404, sec. 207, § 13, 48 Stat. 881, 908 (1934).

71. H.R. CONF. REP. NO. 152-5480, at 12 (1933), *reprinted in* FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 263 (1983) (discussing the Securities Act of 1933).

B. Other Provisions of the Act

Several other provisions of the Act also show a strong intent by Congress to protect investors and provide them with the maximum amount of information possible. The specific exception from the section 4 exemption for dealers selling unsold allotments,[72] though, makes one wonder why Congress would not address this issue directly in section 4 if the loophole were created intentionally. If Congress intended for dealers to be protected from the duties imposed by section 4(c)(3) beyond three years following the offering, why would it not explicitly provide for this instead of leaving these very uncertain questions open?

Further, section 10(a)(3) requires the dealer to update the information in a prospectus after nine months have passed since the effective date.[73] This provision seems to indicate an intent by Congress to continue to protect investors past the effective date and into the future when circumstances require it.

Section 10(a)(3) could also be read, however, to show Congress's specific intent, in creating this anomaly, to define the limits of investor protection. Dealers in unsold allotments can find themselves in an unfavorable position at a time well-past the original offering. They cannot use the final prospectus because section 10(a)(3) requires that it be updated.[74] At the same time, section 5 requires them to use the final prospectus because they are dealing in unsold allotments and cannot claim the section 4 exemption.[75] It is possible Congress built in this post-three-year exemption to protect dealers in this tenuous situation from private actions. This seems unlikely, though, since it would have been much easier for Congress to affirmatively provide protection for these dealers in section 4 or in section 12 than to hope they would find this anomaly on their own.

C. Determining Congressional Intent

Despite the seeming inconsistencies with other provisions in the statute, it is conceivable that Congress originally decided that after ten years, the market in the security would be sufficiently developed to ensure the necessary

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72. 15 U.S.C. § 77d(3)(c); *see supra* Part II.B.
73. 15 U.S.C. § 77j(a)(3).
74. *Id.*
75. *Id.* § 77d(3)(c).

information was available to investors even if unsold allotments of securities are at issue. Considering the 1934 amendment, it is also possible that they felt this would still be true after only three years. This rationale, though, supposes that at least part of the original issue has been sold and traded enough for this information market to be created. This is not necessarily true in all situations.

Placing the Act into its historical context, it is not difficult to imagine pressure from many influential sectors to limit these private actions to a much shorter time period for economic reasons. These changes were undoubtedly new and frightening to those on Wall Street, who would likely have made efforts to find legal protection from these new rules.

Because of the lack of available documentation in the form of committee notes and congressional records regarding the development of section 13, though, it is not possible to know for certain if Congress realized the potential exemption they were creating for dealers of unsold allotments. It does seem safe to proceed under the assumption, however, that Congress did not intend this anomaly, in light of the way it was created, the overall goals of the Act, and the other protections built into the Act.

VI. HOW COURTS HAVE ATTEMPTED TO DEAL WITH THE ISSUE

The few courts presented with this specific situation have acknowledged the problem, and dealt with the issue in differing ways.

A. Appropriateness of the Application of Section 13

A few particularly ingenious defendants have argued the application of section 13. They argue that the three-year limit under section 13 cannot apply to any situation because a registration deficiency means that the securities were never actually registered and therefore never truly "bona fide offered to the public."[76]

In *Bradford v. Moench*, the court decided it "should give the term 'bona fide' its common, ordinary meaning of 'in good faith,' without fraud or deception."[77] The court held "[t]he phrase 'bona fide offered' implies that the offeror has complied in good faith with the requirements of the law. . . . Since the offer of unregistered securities is unlawful, it follows that they are not offered in good faith and thus, the 'bona fide offered to the public' provision

76. *See*, *e.g.*, Bradford v. Moench, 809 F. Supp. 1473, 1486-87 (D. Utah 1992).
77. *Id.* at 1487.

does not apply."[78] The court further reasoned that "the words 'bona fide offered to the public' are not qualified with any word such as 'first' or 'initially' and such an interpretation is not within the ordinary meaning of the phrase" and that "a 'first offered' interpretation of 'bona fide offered to the public' would encourage non-registration."[79] The court recognized the potential for abuse, noting, "Such a policy is contrary to Congress's purpose in enacting the securities laws which was to protect unsophisticated investors from securities fraud."[80]

Other courts considering this argument, however, have determined that a "bona fide" offer simply means an offer that the issuer is prepared to fulfill with the sale of a security, and thus hold that the three-year bar applies from the initial offering date.[81] These courts reason that interpreting "bona fide offer" as meaning only registration statements without defects would render the statute of limitations meaningless.[82] The courts agree that "a more reasonable construction is that 'bona fide' simply means an offer that the issuer is prepared to honor."[83] Therefore, these courts would also recognize the existence of the loophole.

B. Determining the Commencement of the Time Limitation Period

Other courts, having determined section 13 does indeed apply, have attempted to determine when the statutory time period begins to run. Some have applied the "last offered approach" in interpreting the "bona fide offer to the public" provision in section 13.[84] This is an attempt to actively solve the problem by not starting the three-year time limit until after the last offer to the public was made.

These courts recognize the loophole issue, reasoning that:

> To hold [that the three-year limit begins running at the time of the first offer] would be to give individuals a license to sell unregistered securities to whomsoever they wished if they first offered the security to a group of people and, so to speak, "ran the gauntlet"

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78. *Id.*

79. *Id.*

80. *Id.*

81. *See*, *e.g.*, P. Stolz Family P'ship v. Daum, 204 F. Supp. 2d 693, 694 (S.D.N.Y. 2002); Slagell v. Bontrager, 616 F. Supp. 634, 636 (W.D. Pa. 1985).

82. *See*, *e.g.*, *P. Stolz Family P'ship*, 204 F. Supp. 2d at 694-95; *Slagell*, 616 F. Supp. at 636-37.

83. *P. Stolz Family P'ship*, 204 F. Supp. 2d at 694; *see also Slagell*, 616 F. Supp. at 636.

84. *In re* Bestline Prods. Sec. & Antitrust Litig., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 95,070, at 95,751 (S.D. Fla. Mar. 21, 1975).

> for three years. It is doubtful that Congress intended the 1933 Act's goals of registration, disclosure, and private enforcement to be so easily frustrated.[85]

The majority of courts, however, have applied the "first offered approach."[86] Under this theory, "[c]ourts . . . have consistently held that the relevant time period begins from the time the securities are first offered to the public, not the time they were last offered."[87]

These courts have generally used the effective date of the registration statement as the date for which the securities were first offered for sale.[88]

> [The effective] date [of the registration statement] obviously provides a firm and realistic marking point for the commencement of the limitations period, as opposed to defendant's suggestion of the "initial" date upon which one or more of several hundred broker-dealers happens to solicit a customer or mail a preliminary prospectus during the waiting period. And to the extent that the bona fide offering date of an unregistered security may provide an analogy, that date, as indicated, has been fixed by the courts as the date of commencement of trading, again, when the security is available to the public for purchase and sale.[89]

Other courts have found that a similar trigger point applies for over-the-counter securities, holding that they are first offered "when [they are] listed for trading,"[90] or "when list[ed] in the pink sheets."[91]

Under the majority view, therefore, the time limit begins with the first offer to the public and the loophole does indeed exist.

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85. *Id.* at 95, 757; *see also* Hudson v. Capital Mgmt. Int'l, Inc., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 99,222, at 95,908 (N.D. Cal. Aug. 24, 1982) (recognizing the anomalous loophole).

86. *See*, *e.g.*, *In re* Nat'l Mortgage Equity Corp. Mortgage Pool Certificates Sec. Litig., 636 F. Supp. 1138, 1167-68 (C.D. Cal. 1986); Morley v. Cohen, 610 F. Supp. 798, 816-17 (D. Md. 1985).

87. Ballenger v. Applied Digital Solutions Inc., 189 F. Supp. 2d 196, 200 (D. Del. 2002); *see also* Waterman v. Alta Verde Indus., Inc., 643 F. Supp. 797, 808 (E.D.N.C. 1986) (rejecting similar arguments and noting that the three-year period begins "from the date security is first offered to the public"); *Morley*, 610 F. Supp. at 815-16 ("The three year statute of limitations commences to run on the date the securities were *first* bona fide offered to the public."); LeCroy v. Dean Witter Reynolds, Inc., 585 F. Supp. 753, 760 n.4 (W.D. Ark. 1984) ("Most authorities agree that the three-year period commences on the date the security was initially bona fide offered to the public.").

88. *See*, *e.g.*, Finkel v. Stratton Corp., 962 F.2d 169, 173 (2d Cir. 1992); Morse v. Peat, Marwick, Mitchell & Co., 445 F. Supp. 619, 621-24 (S.D.N.Y. 1977).

89. *Morse*, 445 F. Supp. 619 at 622-23.

90. *Ballenger*, 189 F. Supp. 2d at 199.

91. Kubik v. Goldfield, 479 F.2d 472, 475 (3d Cir. 1973); *see also* Sowell v. Butcher & Singer, Inc., No. 84-0714, 1987 U.S. Dist. LEXIS 3788, at *23-*24 (E.D. Pa. May 12, 1987).

C. Tolling of the Time Limitations

Finally, some courts have discussed the possible tolling of the statute to eliminate the discrepancy. Almost all courts that have asked this question, though, have determined that there can be no equitable tolling of the section 13 three-year time limits.[92] Most courts base this reasoning on the plain language of the statute, stating that "in no event" will the actions be allowed beyond the three-year limit.[93] This interpretation is the most logical, as well. This three-year limit must be absolute, "otherwise, § 13 of the Securities Act would create a limitation period of 1 year from the time of a discovery of the fraud, and the three-year provision would serve no purpose."[94]

One court deemed the section 13 three-year time limit to be tollable if the plaintiff pleads with particularity a clearly egregious form of fraudulent concealment by the defendant.[95] However, the Supreme Court largely discredited this rationale in 1991.[96] Even before this ruling, the large majority of courts had decided that even a showing of fraudulent concealment cannot toll the three-year time limit.[97] Courts reason that the "in no event"[98] three-year statute of limitations under the Act is unconditional and not subject to equitable tolling.[99] Therefore, they hold that the Act does contain the loophole, barring any claims brought more than three years after the securities were purchased, sold, or delivered, even if investors alleged fraudulent concealment as grounds for tolling the statute of limitations.[100]

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92. *See*, *e.g.*, Rothman v. Gregor, 220 F.3d 81, 97 n.1 (2d Cir. 2000); Sterlin v. Biomune Sys., 154 F.3d 1191, 1195 (10th Cir. 1998); Caviness v. DeRand Res. Corp., 983 F.2d 1295, 1301 (4th Cir. 1993); Anixter v. Home-Stake Prod. Co., 947 F.2d 897, 899 (10th Cir. 1991); Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1391 (7th Cir. 1990); SEC v. Seaboard Corp., 677 F.2d 1301, 1308 (9th Cir. 1982); Summer v. Land & Leisure, Inc., 664 F.2d 965, 968 (5th Cir. 1981); Griffin v. PaineWebber Inc., 84 F. Supp. 2d. 508, 512 (S.D.N.Y. 2000); Green v. Fund Asset Mgmt., 19 F. Supp. 2d. 227, 232 (D.N.J. 1998); Snyder v. Newhard, Cook & Co., 764 F. Supp. 612, 618 (D. Colo. 1991); *In re* Rexplore, Inc. Sec. Litig., 671 F. Supp. 679, 687 (N.D. Cal. 1987); Turner v. First Wis. Mortgage Trust, 454 F. Supp. 899, 906 (E.D. Wis. 1978); Brick v. Dominion Mortgage & Realty Trust, 442 F. Supp. 283, 289-91 (W.D.N.Y. 1977).

93. 15 U.S.C. § 77m.

94. 69A AM. JUR. 2D *Securities Regulation—Federal* § 995, at 120 (1993).

95. Gale v. Great Southwestern Exploration, 599 F. Supp. 55, 58 (N.D. Okla. 1984).

96. Lampf v. Gilbertson, 501 U.S. 350, 355 (1991).

97. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1263-64 (2001).

98. 15 U.S.C. § 77m.

99. Gilbert Family P'ship v. Nido Corp., 679 F. Supp. 679, 683 (E.D. Mich. 1988).

100. *See id.*; *see also* Richey v. Westinghouse Credit Corp., 667 F. Supp. 752, 754-55 (W.D. Okla. 1986); Benoay v. Decker, 517 F. Supp. 490, 496 (E.D. Mich. 1981).

VII. SOLUTIONS TO THE PROBLEM

A. The Problem with Judicial Solutions

The previous section discussed several of the attempted judicial solutions courts have used in addressing the anomalous dealer exemption. In addition to the problems discussed with each, they all share a singular flaw. Judicial solutions are hindered by one simple fact—the plain language of the statute creates the issue.

Courts are bound first to follow the plain language of a statute in interpreting its meaning. This rule of statutory interpretation is so strong that it prompted Justice Powell to state, "It is axiomatic that [the] starting point in every case involving construction of a statute is the language itself."[101] Therefore, any judicial interpretation of section 13's language that solves the discrepancy is also subject to strong criticism of judicial lawmaking. The final resolution to the problem must come from Congress.

B. The Threat of SEC Action

The Act does provide the SEC with significant powers to pursue dealers violating section 5 beyond the private remedy provided for in section 12(a)(1). These powers include the ability to pursue dealers civilly, as well as to refer them to the Justice Department for criminal charges.[102] The threat of civil or criminal penalties arguably provides sufficient deterrence, ensuring that no section 5 violations occur. This logic, though, ignores the basic premise of the Act—the protection of the investor.[103] None of these remedies are available to the private investor. Therefore, even if the SEC fines and jails a dealer for deliberately disregarding section 5 by not providing a prospectus to an

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101. Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975)).

102. 15 U.S.C. § 77q(a). Specifically, the Act states that it is:

> unlawful for any person in the offer or sale of any securities . . . (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact . . .; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Id.

103. S. 875, 73d Cong., at 1 (1933), *reprinted in* FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 89 (1983).

investor after three years, the investor may not receive compensation in the absence of a section 12 action if no restitution is ordered by the court. It seems inconsistent with the intent of the Act to remove this power from the investors themselves.

Some commentators also argue for an implied private cause of action under section 17(a)(2).[104] Section 17 is the general antifraud provision of the Act.[105] Courts have been reluctant to recognize a private cause of action under this section, though.[106] Although the Supreme Court has not decided if the implied cause of action exists, other decisions from the Court seem to predict that it is unlikely it would do so.[107] In *Transamerica Mortgage Advisors, Inc. v. Lewis*, the Supreme Court held that section 206 of the Investment Advisers Act of 1940,[108] containing language very similar to section 17, did not confer an implied private right of action.[109] Likewise, the court would not likely imply a private action under section 17. Therefore, although a private remedy under section 17 could potentially resolve the issue by providing the investor with an avenue for recovery, the unwillingness of courts to recognize this implied cause of action makes this solution unviable as well.

The overriding goal of the Act is to protect investors. The various actions available to the SEC, while providing some relief by punishing the wrongdoer, seem to be fundamentally out of step with this goal and are at odds with Congress's stated purpose of the Act.[110]

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104. *E.g.*, Charles C. Cohen et al., *A Worthy Restoration Project—Implication of a Private Remedy Under Section 17(a) of the Securities Act of 1933*, SECURITIES REGULATORY UPDATE, Dec. 23, 2002, at 1.

105. 15 U.S.C. § 77q; *see also* 2 FEDERAL SECURITIES ACT OF 1933 § 9.06, at 9-77 (A.A. Sommer, Jr. ed., 2004).

106. *See*, *e.g.*, Kauthar v. Sternberg, 149 F.3d 659, 662 (7th Cir. 1998); Maldonado v. Dominguez, 137 F.3d 1, 6 (1st Cir. 1998); Finkel v. Stratton Corp., 962 F.2d 169, 175 (2d Cir. 1992); Newcome v. Esrey, 862 F.2d 1099, 1104-07 (4th Cir. 1988); Currie v. Cayman Res. Corp., 835 F.2d 780, 784 (11th Cir. 1988); *In re* Wash. Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349, 1351 (9th Cir. 1987); Brannan v. Eisenstein, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986); Landry v. All Am. Assurance Co., 688 F.2d 381, 387-91 (5th Cir. 1982).

107. 2 FEDERAL SECURITIES ACT OF 1933, *supra* note 105, § 9.06, at 9-77 to -79.

108. 15 U.S.C. § 80b-6.

109. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979).

110. S. 875, 73d Cong., at 1 (1933), *reprinted in* FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 89 (1983).

C. A Proposed Legislative Solution

There is a need for a statutory change to eliminate this problem. Courts recognize that "the statutory provisions are likely to produce confusion, and perhaps fraudulent activity."[111] Further:

> The three year period therefore stands as a trap for the unwary investor who fails to receive a prospectus in connection with a slow offering. Obviously, this defeats the very core principle upon which [section 5] is based: At any time after three years from the initial offering, a broker may sell or offer to sell a security without providing a prospectus and be completely insulated from liability under section 12(1).[112]

Courts also realize, however, that their hands are tied, because "the only way to remedy the statutory language is to have the statute amended or repealed."[113]

A rewriting of section 13 could resolve the issue:

> *In no event shall any such action be brought to enforce a liability created under section 11 or section 12(a)(1) more than three years after the security was* <u>*last offered*</u> *to the public, or under section 12(a)(2) more than three years after the sale.*

This simple change would allow the statute to encompass each situation it did in its previous form, but also allow all courts to interpret section 13 under the "last offered approach"[114] and resolve the discrepancy, under the plain language of the statute, in favor of an investor who has been wronged.

VIII. CONCLUSION

The interplay between sections 13, 4(3), and 12 creates an anomalous loophole which limits investor protection. These sections allow a dealer to sell unsold allotments of securities without an accompanying prospectus once three years have passed without giving the investor a private cause of action under section 12. This result is at odds with the fundamental purpose of the Act—protecting investors. A simple change to section 13—replacing "bona fide offered" with "last offered"—would eliminate this loophole, and provide investors with the recourse they need.

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111. Ballenger v. Applied Digital Solutions Inc., 189 F. Supp. 2d 196, 200 (D. Del. 2002).

112. LeCroy v. Dean Witter Reynolds, Inc., 585 F. Supp. 753, 760 (E.D. Ark. 1984).

113. *Ballenger*, 189 F. Supp. 2d at 200.

114. *See supra* Part VI.B.